bioentrepreneur

Brought to you by nature biotechnology

Finance/Funding

Published online: 23 June 2006, doi:10.1038/bioent909

Power dating: a guide to VC courtship

Karen Boezi[1], Elliot Parks[2], Laura Shawver[3], Scott Salka[4] & Chris Erlich[5]

Karen Boezi is at Thomas, McNerney & Partners, One Market, Steuart Tower, Suite 1030, San Francisco, California 94105, USA.

Elliot Parks is at Hamilton BioVentures, 12555 High Bluff Drive, Suite 310, San Diego, California, 92130, USA.

Laura Shawver is at Phenomix Corporation, 5871 Oberlin Drive, Suite 200, San Diego, California 92121, USA.

Scott Salka is at Ambit BioSciences, 4215 Sorrento Valley Blvd., San Diego, California 92121, USA.

Chris Ehrlich is at InterWest Ventures, 2710 Sand Hill Road, Menlo Park, California 94025, USA.

Getting a second date with a venture capitalist requires good planning and an ability to read between the lines.

Chris Ehrlich

Having a great technology, a promising product pipeline and experienced management is the key to success within the biotech industry, but the proof is in the financing. Venture capital funding within the biotech industry accounts for a significant amount of the total funding, averaging roughly a quarter of all funding, including initial public offerings (IPOs) and additional follow-on funding. According to Ernst and Young's 'Global Biotechnology Report 2006', the number of biotech companies totaled 1,415 at the end of 2005, with over three-quarters of those being private and money hungry.

Last year, the life science industry attributed the decline in funding dollars available to private biotech companies to decreasing capital efficiency in the biotech industry, a weak IPO market and weaker post-IPO markets, and shifting investment strategies to later-stage companies. Even so, in 2005 venture dollars invested into biotech were 26.2% of the total raised, slightly greater than the average annual percentage of venture dollar funding of 25%, averaged from 2000 to 2005. This year, a more optimistic outlook is driven by new investors entering the life science landscape, seasoned investors exiting existing companies and looking for new opportunities, and a large coffer of venture dollars up for grabs. Despite this optimism, however, venture dollars have accounted for only 13% of the total funding raised to date, significantly lower than the 26.2% raised in 2005.

The transition from angel money and early-stage federal grants to venture dollars is a daunting task for many startups and, in this hungry market, a competitive one. Establishing and maintaining a relationship with a venture capitalist (VC) can be like maintaining a romantic relationship, where a significant amount of time and energy is committed on both parts. Because cultivating a relationship must start with the initial meeting, it's important to prepare well for that all-important 'first date': know the VC so you can craft your talking points to the background of your audience; be brief—most VCs are attention challenged; bring a solid team—take the folks that can answer the difficult questions; don't stalk—stay in touch, respectfully; and keep in mind that the end goal for the investor is a nice return on their investment.

Most importantly, bear in mind that VCs have seen many hundreds of pitches before yours—for your value proposition to succeed it must stand out from the pack. This means avoiding the common mistakes made by the many other potential VC suitors, and it also means gauging a VC's responses; you will need to be sure you're both speaking the same language.

In what follows, we provide several examples of faux pas that would sink even the most promising of courtships with a VC. Unless you're looking to flirt with disaster, you'd be well advised to avoid them. If your date with a VC goes without a hitch—but you still aren't sure whether your enthusiasm for the relationship is requited—we also translate some typical cues that mean a VC won't be ringing your phone anytime soon.

A closed mouth gathers no feet


VCs Karen Boezi and Elliot Parks.

What happens at that first meeting can make or break the relationship, and some things are sure to raise the commitment warning flags and dampen that budding relationship. Below, we provide a list of the top ten instances of 'wishful thinking' heard by VCs.

10. "The FDA will expedite our product's approval."

Every parent thinks that their child is the cutest in the nursery. But the US Food and Drug Administration does not play favorites and there are specific legal regulations under which drugs qualify for expedited approval. If you make this statement, make sure you can back it up by citing the regulations, or, preferably, with FDA meeting notes. Also keep in mind that expedited approval is sometimes not very expedited versus the normal track so stating this may not buy you much with investors and may hurt your credibility.

9. "We won't need any more pool expansion after this."

Avoid looking naive. Incentive stock options are an important component of the compensation package for employees and management in dynamic and growing companies. A stock option pool that is undersized serves no one's interest. Unless this is the last financing the company will ever need, the option pool will be expanded again down the road to address future dilution as well as growth in head count.

8. "No one could challenge our patents."

Underestimating the competition is never a good idea. Having a patent may prevent others from utilizing your technology. It does not guarantee that your competition won't design around you. Furthermore, a patent does not guarantee your right to develop a product or service as the use of the technology in the patent may infringe on other intellectual property. Don't neglect your need to assure your 'freedom to operate' in your chosen space.

7. "Our financial projections are conservative."

Financial projections should be realistic. If they are too conservative, they undersell the opportunity. If they are overly optimistic, they can't be painted over simply by labeling them as conservative. Such financial forecasts make the management team look naive.

6. "The target market for our product is $500 billion worldwide."

Be realistic regarding the market opportunity. It is highly unlikely that one product is going to capture an entire market as patients tend to be segmented in any given area by severity of disease and many other factors. The salient questions are, What part of the market opportunity can the company's product penetrate and why, how is the company going to capture that market share, and how rapidly?

5. "Everyone will use our product."

Never say 'everyone.' Be realistic, and specific, about how the company intends to penetrate the market. As stated in number 6 (above), be careful to address severity of disease issues in product positioning. Also be cognizant of workflow issues in the provider setting, which might affect adoption.

4. "Raising that amount of capital would be too dilutive."

The goal is creating a lucrative exit for your investors, yourself and your employees. You can't save your way to success. Take the capital when it is available and grow the company to success. Remember the famous venture adage "a smaller piece of a bigger pie is often a bigger piece."

3. "This will be the last private round."

We might all hope that this is the last private round of financing. But, it is most often not the case. It is better to under-promise and over-deliver, than the reverse.

2. "Our team has done this all before."

No one can predict the future, not even you. If you have actually done this before, you know all too well that unexpected obstacles will arise. Expect it to take more time, and cost more money than anticipated. Experienced investors do.

1. "We have no competition."

There are a lot of smart people in this world, so if a market is worth going after, you will have competition, at least indirect competition (that is, other companies going after the same patients or providers). Not knowing who and where your competition is in development is mistake number one, and a disaster waiting to happen. And, by the way, creating a new market is harder than penetrating an existing market.

Presenting a credible story is key to leading your company and securing funding. Be realistic and engender confidence that you truly know where you are going and how you will get there.

Lost for words

Entrepreneurs need to have their antennae out too during these first dates. After a few such meetings, they might begin to recognize these ten commonly spoken phrases that VCs use that really mean "No."

CEOs Laura Shawver and Scott Salka.

10. "I want to, but I can't get my partners to agree."

Typically, a CEO develops a good relationship with just one partner in a firm and relies on that partner to sell the rest of the firm on the investment, so it is possible there is a shred of truth to this statement. More often, however, this is just a convenient excuse that really means "No."

9. "We like the deal, but we can't lead. Let us know when you find a lead."

This probably means that the VC likes the deal, but not enough to actually exert the effort required to complete due diligence. That said, if the entrepreneur can find somebody else to do the heavy lifting, this 'armchair VC' would be happy to piggyback!

8. "So you already have a lead? Too bad: we are only investing in deals we can lead."

Although it is true that fund sizes have increased in recent years, putting immense pressure on VCs to put more money into each deal, no firm truly expects to lead every deal. This is just another polite, but not-so-original way to say "No."

7. "You're raising $20 million? We think you need at least $40 million to reach the next value inflection point."

There will always be differences of opinion regarding the size and timing of equity financings. That said, if the VC really likes your deal, she will work very hard to convince you her plan is best. If this statement is not followed immediately by "...and I'm going to convince you of why..." it really just means "No."

6. "You're raising $20 million? We think you need to raise only $10 million."

Just like number 7 (above), this reason is an example of "sometimes you can't win." The same business plan presented to a number of investors will lead to the same number of different responses. As in the case above, if the VC isn't rolling his sleeves up as he's saying this, just move on to the next one.

5. "We like the deal, but we can make only one more investment from this fund."

When VC funds get down to their last investment, they often will have a stricter set of investment criteria. For example, if they have already invested in a cancer company, they may not wish to invest in another cancer company with their last investment. That said, this is an easier way for most VCs to say "No." Either way, you're not getting any money from this firm, so stop wasting your time.

4. "We like the company, but it's a little too early-stage for our fund."

No matter what stage you are at, there will always be numerous VCs that say you are just not far enough along. Take this for what it really means: "No!"

3. "Great story, but it's too late for us; our fund's all about early-stage opportunities."

Especially hard to swallow when during the previous financing round, all you heard was phrase number 4!

2. "If you can show us a little more traction, we'll invest."

Danger! This wicked variation on number 4 can force the company to spend its last dollar trying to meet a near-term milestone. Unfortunately for the entrepreneur (but so perfect for the VC!), this makes the company much more vulnerable to poor deal terms.

1. "If only we had seen you sooner! Your company's just too competitive with another investment we just made."

Often times this is only a perceived competitiveness. More often, it's just a long-winded way of saying "No."

Conclusions

For those who've had previous trysts with investors, raised significant amounts of money but have little to show for it, any prospective date with a VC is going to be tough. In the end, though, if one has a sound business plan, there is usually a saddle for every seat. The challenge is to work hard to find the one that fits!

Remember: the first date is just the beginning. Managing relationships with VCs takes skill in dealing with a range of issues from strategies regarding location to managing multiple term sheets and how to 'play the field' while still keeping them interested.

Acknowledgments

This article is based on a session presented at the Biotechnology Industry Organization's annual convention on April 10, 2006 in Chicago, Illinois, featuring C.E. as moderator and K.B., E.P., L.S. and S.S. as panelists. The authors thank Amy Blackley of Porter Novelli Life Sciences for her help in organizing the session and in the preparation of this article.